TESTIMONY OF PETER H. BLESSING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
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Chairman Neal, Ranking Member Tiberi, and Members of the Subcommittee, thank you for inviting me to testify. I am a lawyer in private practice with the law firm Shearman & Sterling LLP. I also teach International Taxation as an adjunct professor in the J.D. program of Columbia Law School. I serve as First Vice Chair of the Tax Section of the New York State Bar Association, member of the Executive Committee of the USA Branch of the International Fiscal Association, and Council member of the American Bar Association Tax Section (former chair of its Committee on Foreign Activities of U.S. Taxpayers). I have authored a treatise on U.S. income tax treaties.[1] My comments today are made as a practitioner and not on behalf of any organization or institution.

I. The Problem

The principal problem that my remarks will address is the tax gap attributable to unreported investment income and what is being done or might be done. The extent of the problem has been the subject of much speculation and is not readily susceptible of accurate measurement, though attempts have been made. While the range of estimates is broad, the numbers are in any event large. The problem has come to the fore in certain well-publicized incidents involving non-U.S. banking institutions holding unreported funds of U.S. taxpayers.[2]

The reasons for the problem have been better articulated. The problem is not a new one, but has become much larger in amount as the result of a variety of factors such as a more globally stable economic environment and ease of ability to open accounts and transfer funds, and marketing by persons in offshore jurisdictions. The problem has received wider vetting more recently as the result of factors such as the budget gap and search for revenues in the U.S. and abroad, as well as enhanced attention to compliance and enforcement in the U.S. and abroad.

II. Working Towards a Solution

As a preliminary matter, I wish to emphasize that the last few months have shown that much is already being done to address the problem, through mechanisms and procedures in place. The U.S. is not alone in this endeavor and today more than ever there is real and productive joint activity and a tangible opportunity for greater cooperation in the future. Second, Treasury and the IRS have been taking meaningful steps recently to reduce the likelihood and dimension of future incidents. Perhaps the most important factor in that regard, and I particularly wish to emphasize this, is the appropriation of substantial additional amounts in the IRS budget for enforcement, as contemplated by the Obama Administration's budget.

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[1] Income Tax Treaties of the United States (Warren, Gorham & Lamont, 1995).

[2] *See, e.g.*, Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs of the U.S. Senate ("PSI"), "Tax Haven Banks and U.S. Tax Compliance" (July 17, 2008), 2008 TNT 139-15.

Faced with a problem of the magnitude addressed here, there can be a temptation to take action, and dramatic action, quickly. However, precisely because the problem is global and implicates the operations of the global financial system, proposed solutions must be tempered with hard examination and review. Tax measures adopted in response to legitimate concerns can have unanticipated and unhappy consequences from the standpoint of economic efficiency. One must be careful not to fight yesterday's war, in this context especially because there is a real economic efficiency cost to reporting requirements and behavioral deterrents and proscriptions. I would only caution that these considerations not be overlooked in the important job of crafting provisions to address the problem.

It never will be possible to eliminate criminal or fraudulent behavior in respect of financial accounts, even such behavior on a very large scale. As recent events have shown, that phenomenon is certainly not limited to the cross-border sector. But better controls can both serve as a deterrent and facilitate the early detection of such activity. The challenge is to have controls that do not place an undue burden on the benefits that come with free flows of capital across borders.

The issue of taxation in respect of cross-border capital flows has many facets. A hugely important one is which items of income should be subject to tax by the source country, which goes hand in hand with the question of how the income should be sourced. For example, the issue of whether source country withholding tax should be imposed on dividends at all given that no withholding tax is imposed in interest received by foreign persons or often (under treaties) on royalties, even though both types of payment generally are deductible, has been raised over the years. The Stop Tax Haven Abuse Act introduced by Senator Levin and Representative Doggett would address the substantive rules of withholding tax in respect of certain types of income (from swaps, etc.) but there would be financial market consequences that must be considered.

Another aspect of the question is whether a withholding tax system similar to that in, e.g., Switzerland, in which amounts are withheld pending submission of proof of residence of the beneficial owner (rather than not withholding based on a self-certification). Professor Avi-Yonah has suggested a variation of this approach in previous testimony before this Subcommittee, which in practice would apply only to non-treaty countries, including, in general, tax havens.

With reference to enforcement matters, the objective of exchange of information is the collection of tax. Apart from our income tax treaty with Canada, there are few provisions in our bilateral income tax treaties offering assistance in the collection of tax owed by our residents. That is typical of income tax treaties generally, and reflects the "revenue rule" whereby the U.S. courts, as the equivalent bodies in many foreign countries, have generally declined to permit the domestic legal system to be used to enforce the tax laws of another country, although certain cracks in the rule have appeared in limited contexts. Given our global economy and the volume of cross-border capital flows, a reconsideration of the considerations policies behind the revenue rule may be appropriate in the context of our tax treaty policy.[3]

[3] A development in this regard is the proposed EU Directive referred to in footnote 13 below.

In the remainder of my statement, however, I will focus on compliance initiatives.[4] In particular, I will address tax treaty information exchange procedures and the IRS-initiated qualified intermediary procedures, both of which I understand to be of particular interest to you in connection with this hearing.

III. Information Exchange in Civil Tax Matters

I first will briefly address certain issues in respect of the bilateral agreements entered into by the United States and used by the IRS[5] to attempt to obtain tax information from other countries in connection with compliance and enforcement. I will not address agreements relating to criminal matters, or multilateral agreements.[6] It should be noted that these agreements are directed at information available to another country, as opposed to information available to a taxpayer or third party recordkeeper. The Internal Revenue Service and the Department of Justice rely on the summons power under sections 7602 and 7609 of the Internal Revenue Code to compel the production of information from private parties.

A. Background

There are two principal forms of bilateral agreements primarily used by tax authorities for the exchange of information. These are the article of income tax treaties that governs the exchange of information (included as Article 26 in the U.S. Model Income Tax Treaty) and Tax Information Exchange Agreements ("TIEAs").

1. Article 26 of U.S. Model Treaty.[7] Article 26 of the U.S. Model Income Tax Treaty, "Exchange of Information and Administrative Assistance," calls for the relevant authorities of the contracting countries to exchange tax information as necessary for carrying out provisions of the treaty or the domestic laws of the parties. Any information received is to be treated as confidential "in the same manner as information obtained under the domestic laws" of the requesting country and is to be used only in connection with proceedings relating to the taxes in question. While the requested country is to "use its information gathering measures to obtain the requested information, even though that [country] may not need such information for its own purposes," that country is not required to supply information that is not obtainable "in the normal course" of its administration. Though there are limits on the obligation of a country to provide certain information, such as information that would disclose trade or business secrets, those

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[4] In connection with a public hearing before the Senate Committee on Finance on July 24, 2008, the Staff of the Joint Committee on Taxation prepared an informative report, "Selected Issues Relating to Tax Compliance with Respect to Offshore Accounts and Entities," JCS-65-08 (July 23, 2008).

[5] The Department of Justice also may attempt to use these agreements in (criminal) tax cases handled by it, but for various reasons the agreements have not proven very useful in practice.

[6] For example, the Convention on Mutual Administrative Assistance in Tax Matters is a multilateral agreement sponsored by the OECD and the Council of Europe that was written in 1988 and has been signed and ratified by thirteen countries. This Convention contains an exchange of information provision; however, it is subordinate to EU Directives and therefore has limited applicability at this point, given that the parties are all European except for the U.S.

[7] U.S. Treas. Dep't, Model Income Tax Treaty, Nov. 15, 2006, art. 26.

limits are not to be construed in a way that allows the requested country to decline to supply information because that information is held by a bank or other financial institution.

As is evident by the scope of information subject to production under a typical such provision, bank secrecy rules currently may excuse production. This limitation also may be explicitly stated (e.g., diplomatic notes to Art. 28 of the treaty with Luxembourg, article 26(3) of the treaty with Switzerland). Reflective of these exceptions, Austria, Belgium, Luxembourg and Switzerland entered reservations to the Exchange of Information article of the OECD Model Income Tax Convention. However, in the last weeks, each of these countries notified the OECD that they are withdrawing that reservation.

2. TIEAs. TIEAs are agreements between two countries establishing policies and procedures regarding the exchange of information between the two contracting parties, generally in situations in which the parties do not have a comprehensive bilateral income tax treaty containing provisions such as referred to above. They generally describe what information must be included in a request for information and timing guidelines, as well as specific definitions of precisely what taxes are covered and which taxpayers are covered by the agreement. TIEAs also usually include provisions allowing the requesting party to enter the territory of the requested party if necessary to interview individuals or examine records, and they describe the conditions under which a request for information may be declined (such as when the disclosure of the information would be contrary to the public policy of the requested party). The first one was entered into in 1984 between the U.S. and Barbados, but the agreements have become a widespread tool for the U.S. and other OECD countries, in particular, to obtain information needed for tax enforcement.

The OECD Agreement on Exchange of Information on Tax Matters,[8] which is not itself a binding instrument, contains two models for TIEAs, one that is a traditional bilateral agreement and another that contemplates an "integrated bundle of bilateral treaties" creating a multilateral agreement. The Agreement includes provisions typical of TIEAs historically, and goes a bit further in some areas. For example, many TIEAs include provisions that a requested state cannot deny a request for information solely because that information is held by a bank or financial institution, but the OECD model includes a requirement that each contracting party is to ensure that its authorities have the authority to obtain and provide upon request information held by banks or other financial institutions. Another important provision is the requirement that requests can only be made in cases where the identity of the taxpayer is known, a case has been made, and all other means available within the requesting state to obtain the information have been pursued and exhausted.

Another document worth mentioning in this context is the EU Savings Tax Directive.[9] This savings tax directive was adopted in 2003 and went into effect in 2005. Recognizing that coordination of national systems is not sufficient, the agreement is intended to result in an EU-

[8] Organisation for Economic Cooperation and Development (OECD), Agreement on Exchange of Information on Tax Matters (Paris: OECD, Apr. 2002) developed by the OECD Global Forum Working Group on Effective Exchange of Information.

[9] European Union Council Directive 2003/48/EC, 3 June 2003.

level system wherein all member states will exchange tax information automatically to all other member states on any interest paid on savings to residents of those other member states. It includes rules concerning the details of the information to be reported, as well as the frequency and mechanics of reporting. In response to the discovery of several loopholes within this directive, such as through the use of trusts, foundations and other investment vehicles, a proposal to amend it was proposed in November 2008, as discussed below.

B. Recent Developments

In the last number of months, there have transpired certain developments relating to the exchange of information in tax cases that merit particular note.

1. TIEA Between the U.S. and Liechtenstein.[10] On December 8, 2008, the U.S. and Liechtenstein signed a TIEA, the first ever executed by Liechtenstein, that improves on various of the shortcomings that exist in other agreements, primarily in the area of protections based on bank secrecy laws. For example, the TIEA does not contain the provision present in the OECD model allowing bank secrecy policies to continue to the extent they do not "unduly prevent or delay" the effective exchange of information. In connection with the execution of this TIEA, the U.S. extended Liechtenstein's treatment as a jurisdiction satisfying the requirements of the "qualified intermediary" program[11] through the end of 2009 with the understanding that, in that time, Liechtenstein will enact legislation loosening its bank secrecy laws as required to comply with the TIEA. The TIEA will allow the U.S. to ask for information relating to 2009 and subsequent years.

2. ICG Report on Withholding Procedures.[12] This report was prepared by the Informal Consultative Group ("ICG"), which includes representatives from the financial industry as well as from some OECD member countries, established by the OECD's Committee on Fiscal Affairs, and discusses the relevant procedural problems and makes recommendations for consideration by the CFA on best practices that might be adopted by countries, to facilitate the claiming of treaty benefits by investors, minimize administrative costs and allocate them properly, and allow source and residence countries to ensure proper compliance. The report recommends a system that looks very similar to the U.S. qualified intermediary system. Recommendations include that withholding be relieved at source rather than a refund procedure, and that countries develop systems for pooled reporting by intermediaries who would enter into contractual arrangements with the source country and would be subject to audit by an approved independent reviewer. Differences from the QI system are that the identities of beneficial owners of payments would be disclosed to the source countries, and a "reason to know" (rather than "actual knowledge") standard would be applied.

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[10] Agreement Between the Government of the United States of America and the Government of the Principality of Liechtenstein on Tax Cooperation and the Exchange of Information Relating to Taxes, Dec. 8, 2008. *See* Press Release of the U.S. Treas. Dep't on 8 Dec. 2008 (HP-1320).

[11] This program is discussed further below.

[12] OECD, Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors (Jan. 12, 2009).

3. New Proposed EU Directives. In November 2008, the European Commission announced a proposal to amend the existing EU Savings Tax Directive.[13] This proposal specifically targets certain loopholes that have allowed taxpayers to avoid paying taxes in their home jurisdiction, such as through the use of trusts or foundations and through the restructuring of certain income to render it outside the existing directive's definition of interest payments. The proposal includes trusts and foundations within its scope and would extend the directive to include "income equivalent to interest payments." It remains to be seen how the EU member states, as well as certain non-EU countries such as Liechtenstein and Switzerland, both of which signed onto the 2003 Directive, will respond to this proposal.

On February 2, 2009, the European Commission also announced a proposal for a new Directive on mutual assistance for the recovery of claims relating to taxes.[14] This Directive would replace the existing directive on the exchange of information dating from 1977. A key element of the information exchange segment of this proposal is that it would not allow tax authorities to use bank secrecy as a basis for refusing to cooperate in a request for tax information.

4. Domestic Legislation. A bill sponsored by Senator Baucus[15] contains certain reporting, due diligence, statute of limitation and penalty provisions in respect of funds transferred to or held in offshore accounts. Further, a bill for the Stop Tax Haven Abuse Act[16] has been introduced by Senator Levin and by Representative Doggett in the Senate and House, respectively, targeting certain offending jurisdictions through a variety of measures. Section 101 of the bill lists 34 "offshore secrecy jurisdictions." The bill would require special treatment for dealings in respect of those countries, including extensive reporting requirements for U.S. financial institutions doing certain types of business in these jurisdictions. The bill would also target certain loopholes in the Internal Revenue Code relating to foreign trusts and would increase penalties for the promotion of abusive tax shelters. The bill would amend the USA PATRIOT Act to extend provisions aimed at fighting money laundering so that they would also apply to foreign jurisdictions and financial institutions that "impede U.S. tax enforcement."

5. Retreat from Bank Secrecy Reliance. In response to the pending G-20 blacklist and pressures from particular countries, including the U.S., France and Germany, a number of countries have recently announced that they will adopt "OECD standards" of exchange of tax information and will not claim bank secrecy as preventing production. Nevertheless, these statements usually are coupled with the caveat that a new agreement must be negotiated, which could result in delay.[17] Some have been cautiously worded to the effect that no fishing expeditions are permitted and that "justified" requests will be honored.

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[13] Commission of the European Communities, Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments (Brussels: Nov. 13, 2008), 2008/0215.

[14] Commission of the European Communities, Proposal for a Council Directive on administrative cooperation in the field of taxation (Brussels: Feb. 2, 2009), 2009.

[15] Discussion Draft, TNT 46-19.

[16] S. 506, H.R. 1265 (introduced March 2, 2009).

[17] The Swiss Ministry of Finance, however, has already been given permission to start negotiations.

C. Problems That Should be Addressed

Although significant progress has been made, the commitments that countries have made generally are to conform to the standard OECD provision. The information exchange provisions therein, as in existing U.S. income tax treaties and TIEAs, as a general rule, contain certain shortcomings. In addition, the time to get from "here" to "there" could be substantial. Certain relevant issues are as follows.

1. As noted in the press, various countries have agreed orally that they will not rely on bank secrecy provisions as a defense against providing information (as they had previously in cases not involving asserted crimes or tax fraud), at least in certain contexts, and not to limit exchange of information to cases involving asserted cases of criminal conduct or tax fraud. Not all countries have agreed. Information exchange provisions must be clearly worded to prevent invocation of domestic bank secrecy or similar provisions to the extent possible, certainly to the extent tax avoidance is at issue, and to eliminate any express or implied restriction to cases involving criminal conduct or tax fraud.

2. In the case of certain existing agreements, the agreements will have to be revised. If that process requires negotiation, the issues that need to be negotiated should be clearly identified and the projected schedule for the process of negotiation and subsequent ratification should be agreed.

3. In some cases, domestic implementing legislation will be required. A problem experienced by the U.S. and other OECD countries is that certain countries have signed TIEAs but have not followed through with domestic measures required to make the agreement effective. It is important that a timetable be agreed to and if implementation is frustrated, including by excessive delays, to consider sanctions or other measures.

4. Most countries, including the U.S., do not wish to be the recipient of an information request that is open-ended (as in a John Doe summons) and which might be characterized as a fishing expedition. Information exchange provisions typically do not condone requests covering a class of unidentified persons, as opposed to specific identification of the individual, at a minimum. There are situations, however, when reasonable efforts to achieve compliance may require the use of broader requests. Related to this is whether information will be supplied if the case involves only suspected tax avoidance rather than a case where significant evidence has been collected.

5. A nagging problem is the amount of time required for the production of specifically requested information. In the context of an examination, delays in producing the material requested can be determinative.

6. If information is located outside of the territory of the requested country, it is not required to be produced under the standard language. Given the global nature of capital flows and business, consideration should be given to expanding the scope to reach this information if available to the requested country.

7. Typically, only information necessary to carry out the requested country's domestic tax laws is required to be produced, and not information available but relating for example only to the requesting country's tax law. This can be a significant shortcoming.

8. It often can be important to the proof of a case to have access to testimony and to original documents rather than just copies. An optimal provision would accommodate these needs. Such a provision is included in the U.S. Model Income Tax Treaty and, e.g., the treaty with Sri Lanka, but is not included in the OECD Model Income Tax Treaty or U.S. treaties based thereon.

9. Various technical issues can exist under the provisions, such as whether the category of relevant persons is defined broadly enough.

10. The exchange of information should be automatic and electronic to the greatest extent possible. Automatic exchange avoids subsequent waiting and permits, with today's computerization of data, the ability to store, categorize for retrieval, and search the information and to use it as a matter of course. If the information can be assimilated, it would avoid the need to later engage in what might be termed a fishing expedition. Although in the past the sheer volume of information would have been a counter-consideration, to the extent information can be furnished in electronic form that should not be a serious drawback.

D. Use of Black Lists and Possible Sanctions

Recent developments have shown that, used carefully, black lists can be a very effective tool to convince certain countries that information exchange is in their best interest. In particular, the announcement that a new blacklist would be considered by the G-20 nations and circulation of a preliminary list of countries considered for that list was evidently instrumental in causing a number of countries to agree to OECD standards on information exchange. The sanctions for inclusion on the list were not established but some considered are disallowance of a deduction for payments to a resident of such a country or encouraging international financial institutions to withdraw investments from blacklisted jurisdictions.

As discussed above, the Stop Tax Haven Abuse Act contains a proposed blacklist of 34 countries. The provision permits the Secretary of Treasury to add countries. It imposes certain conditions to removal of a listed county. Under Section 102 of the Act, the consequences of being a listed country would be the same as those of being a money laundering jurisdiction and could include the prohibition of or imposition of conditions upon the opening or maintaining in the U.S. of a correspondent account for any financial institution based in the listed country. The Act also extends other sanctions currently available to combat money laundering to the fight against tax evasion, aimed at foreign jurisdictions and financial institutions that "impeded U.S. tax enforcement." This would include increased record keeping and information reporting requirements by U.S. financial institutions dealing with offending jurisdictions.[18]

[18] *See also* The Fraud Enforcement and Recovery Act of 2009, which would subject the transfer of funds with an intent to avoid tax to the criminal money laundering statute.

The Internal Revenue Code already includes a provision that authorizes the Secretary of Treasury, if he determines that the exchange of information between the U.S. and a foreign country is inadequate to prevent evasion of U.S. income tax by U.S. persons, to deny the benefit of the portfolio interest exemption to persons within such foreign country or to an address or for an account within such country. While the provision has been in force since 1993, it does not appear to have been employed.

It must be emphasized that a blacklist must be used with care. There should be a gap of time between when a country is proposed to be included on such a list and the final decision to include the country, in order to permit affected countries to decide whether to change the information-limiting rules. Likewise, once a country is included, there should be flexibility for the Secretary to remove the country if compliance has been achieved.

Not all of the countries listed in the Stop Tax Haven Abuse Act seem appropriately included, and developments have occurred since the list was formulated. Not only may the list be overinclusive in certain respects, it may be underinclusive in certain other respects. The list has inconsistencies with countries identified by the OECD. Again, it is important to maintain flexibility in adding and removing countries from such a list.

A blacklist is not without its drawbacks, such as the determination by a blacklisted country to withdraw any cooperation whatsoever or the possibility of retaliation by a blacklisted country through, e.g., prohibiting awarding government contracts to a U.S. company. Nevertheless, the downside of a blacklist may be deemed insufficiently problematic to offset the upside potential.

E. Greater Reliance on Financial Institution Reporting

As an alternative to relying primarily on other countries to provide information, in theory a system of increased reporting by financial institutions handling payments to U.S. persons could be implemented. The rationale would be that, while the U.S. government cannot force another country to cooperate, it can force a financial institution that handles U.S. source payments or otherwise is subject to its jurisdiction (or even if not can be subjected to indirect sanctions) to comply with its rules.

The currently operative regime in that respect is the qualified intermediary regime discussed below. As discussed below, the scope of the required information could be expanded.

A more radical approach is proposed in the Stop Tax Haven Abuse Act. Under that Act, financial institutions would be required to file voluminous reports covering virtually all financial transactions involving an "offshore secrecy jurisdiction." The reporting required provision would seem to impose an overwhelming burden on financial institutions, and their ability to comply and the costs of compliance are factors that should be weighed.

F. Two-Way Street

The information exchange process is of great interest to U.S. tax authorities, but for similar reasons it is of great interest to many foreign tax authorities. Just as the U.S. would like to have another country identify the beneficial owner of an account and to affirmatively apprise the U.S.

tax authorities of accounts beneficially owned by U.S. persons, foreign tax authorities would like the converse.

Issues that may present themselves in this regard include that the IRS Form W-8BEN is not required to be filed with the IRS, so that the IRS has no record of the identity of payees in the QI system. The IRS in theory obtains the identity of payees that are not in the QI system on Form 1042S, but the GAO Report indicates that the information often has not been processed in a way to make it accessible.

Further, the U.S. does not collect information concerning the beneficial owners of entities, including disregarded entities.

A third example is that there is no reporting in respect of bank deposit interest (other than payments to Canadian persons.[19] An attempt during the Clinton Administration to extend bank interest reporting broadly[20] was abandoned.

IV. QI Program

A. General

A qualified intermediary ("QI") is a foreign financial intermediary (or foreign branch of a U.S. intermediary) that has entered into a QI Agreement with the IRS and acts in accordance with that Agreement, governing certain withholding and reporting obligations in respect of U.S. source income.[21] In general, a QI agrees to assume certain documentation and reporting requirements in exchange for simplified information reporting for its foreign account holders and the ability not to disclose account information (which may be proprietary and disclosure may result in information going to a competitor). The QI Agreement has a 5-year term, but may be renewed if the QI is in good standing.

A QI may assume primary withholding responsibility and/or primary Form 1099 reporting and backup withholding responsibility for a payment. In such a case, which will be disclosed on the Form W8-IMY provided to a downstream payor, the payor may treat the QI as a payee, and the QI must satisfy whatever withholding is required.[22] Alternatively, a QI may determine not to assume primary foreign person withholding and/or not to assume primary Form 1099 reporting and backup withholding. In such a case, the QI acts like a typical "nonqualified" intermediary or foreign flow-through entity, and the downstream payor is required to report and, if applicable, withhold based on the payee-related documentation attached to the Form W8-IMY.

According to a 2000 IRS News Release, the IRS views the QI program as the cornerstone of the revised withholding tax rules that came into effect January 1, 2001. Although the preponderance

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[19] Reg. § 1.6049-8.

[20] REG-126 1100-00, 2001 TNT 11-17.

[21] The terms of the QI Agreement are set forth in Revenue Procedure 2000-12, as amended.

[22] A similar procedure is provided for a "Withholding Foreign Partnership" and for a "Withholding Foreign Trust."

of cross-border payments by dollar amount is not made via QIs, that number is likely skewed by certain large payments. The IRS has over 5,000 QI Agreements currently in force.

The benefits available to a QI are, first, simplified information reporting procedures for the QI, as only withholding rate pool information is provided to U.S. custodians (or other downstream intermediaries). Second, the Agreement permits collective refund procedures (thus not requiring customers to individually file for refunds). Third, the identity of non-U.S. customers need not be disclosed to withholding agents (who might be competitors) or to the IRS.

The benefits derived by the Treasury and IRS from the QI program are that the IRS has a greater degree of assurance that proper withholding is being made. A QI agrees to undertake additional obligations that are not imposed on normal withholding agents. Of particular importance, they agree to: (i) follow specified account-opening procedures based upon the "know your customer" rules of the applicable jurisdiction (which rules will have been reviewed and approved by the IRS as adequate); and (ii) have the procedures they follow be subject periodically to an external audit (currently, during the second and fifth years of the agreement) pursuant to standards set by the IRS.

In considering alternatives to a QI program, the most obvious would be to require disclosure of the identity of the beneficial owner to be made at each level down the withholding chain, and reported to the IRS, as in the case for nonqualified intermediaries. The IRS, however, would lose the benefit of the review available at the point in the chain where direct contact with the beneficial owner is most likely to exist. Another alternative would be to withhold on investors from countries with which the United States does not have a bilateral income tax treaty and require evidence of residence to obtain a refund. This approach, however, would be considered overly frictional and disruptive of desirable capital flows. A third approach, which would not really be an alternative, would be to modify the program, such as to require that Forms W-8BEN be furnished to the IRS (see below).

B. Assessment and Shortcomings

The U.S. Government Accounting Office reported on the QI program in December 2007 in its report "Tax Compliance: Qualified Intermediary Program Provides Some Assurance That Taxes on Foreign Investors Are Withheld and Reported, but Can Be Improved."[23] The GAO Report concluded that the QI program "contains features that give IRS some assurance that QIs are more likely to properly withhold and report tax on U.S. source income sent offshore than other withholding agents." The reasons given are the QI's working relationship with the ultimate beneficial owner, the enhanced responsibilities of a QI as compared with other withholding agents, and the external audit procedure.

The GAO Report suggested certain measurement and procedural enhancements. The GAO Report first thought it would be useful to know in what proportion of cases withholding agents rely solely on self-certified documentation without ability to otherwise verify. It also found it troubling that large sums reported by QIs could not be associated with a particular jurisdiction,

[23] GAO-08-99 (Dec. 19, 2007), 2008 TNT 18-47. This report elaborated on the GAO testimony given May 3, 2007: GAO, "Tax Compliance: Challenges in Ensuring Offshore Tax Compliance," GAO-07-731G (July 2007).

and suggested that the IRS investigate and take corrective action. As far as actual changes to the procedures, the GAO Report suggested that the "Agreed-upon Procedure" ("AUP") standards[24] be enhanced by requiring the external auditor to report any indications of fraud or illegal acts that could significantly affect the results of the review, not just indications of "know your customer rule" violations and information received as the result of self-reporting by the QI. Finally, the GAO Report recommended that QI Agreements require electronic filing of data (with exceptions made by IRS waiver), and that the IRS improve its data processing capabilities.

Certain other shortcomings with the operation of the QI program may be noted.

1. Financial institutions have a conflict of interest, in that their customer relationships may be adversely affected by compliance.

2. U.S. owners of foreign securities are not required to be reported.

3. Interposed foreign entities have been used to provide a W-8BEN showing a non-U.S. person. This problem is of course not unique to QI withholding.

4. External "audits" have not been entirely effective. They are required only to be in accordance with AUP standards, which means that they do not constitute an audit or a review and therefore are not an expression of an opinion by the auditor. Related to this is that the standard of audit may be too rigid to permit auditors to exercise discretion and there is no requirement to act upon the findings of an audit.

C. Announcement 2008-98

In response to the GAO Report (and a few months after further criticism in the July 2008 PSI hearing), the IRS issued Announcement 2008-98, which proposed changes to the model QI Agreement and to the audit procedures.[25] These changes, proposed to apply to calendar year 2010 and thereafter, would include the following:

1. Provide that a QI must notify the IRS within 60 days of the time that the QI becomes aware of "a material failure of internal controls" relating to its performance under the QI Agreement, any employee allegation of such failures, and any investigation by regulatory authorities of such failures. Failure by the QI to so notify would be an event of default under the QI agreement.

2. Require the external auditor to associate a U.S. auditor with the audit and to require the U.S. auditor to accept joint responsibility for performance of the audit procedures.

3. Require the auditor to examine the account holder files selected for testing to ascertain whether there are indicia (e.g., signing authority) that a U.S. person might control an account purporting to be foreign controlled. The definition of an "account holder's file" would

[24] International Standard in Related Services 4400, "Engagements to Perform Agreed-upon Procedures Regarding Financial Information" (ISRS 4400).

[25] The audit procedures are set forth in Revenue Procedure 2002-55.

be substantially expanded to include "any documents, reports or other information generated or received for purposes of anti-money laundering, know-your-customer, tax or other laws, and any other account information."

4. Require the auditor to add additional procedures for fact gathering, including, e.g., identifying the persons charged with the oversight of performance under the QI Agreement and the authority given them to prevent, detect and correct failures, and requiring the auditor to report to the IRS relevant facts.

The IRS has received comments on this announcement from certain audit firms and QIs. Clearly, a balance will need to be struck between the interests of a viable review and audit procedure and the increased costs associated with the proposed procedures, which may be beyond the ability of smaller QIs to comply. In particular, certain of the additional procedures in effect would cause the audit to go beyond an AUP, which had previously been agreed among the QIs, audit firms and IRS, raising issues as to how the review may be conducted under the accounting profession's audit standards. Nevertheless, it seems clear that strengthening of the external review process is appropriate.

D. Concluding Remarks on QI Program

I have the following concluding comments and suggestions in respect of the QI program.

1. The QI program overall is well-conceived and plays a key role in the U.S. withholding tax system, and should be supported, including with adequate funding.

2. QIs should be required to report U.S. owners holding only foreign securities.

3. Consideration should be given to requiring QIs (and as appropriate nonqualified intermediaries) to use information available to them under money-laundering or other rules to identify cases in which the beneficial owner(s) of a non-US entity providing a W-8BEN appears to be a U.S. person or persons (looking through, as appropriate, entities up the ownership chain).

4. Consideration should be given to requiring QIs to provide the Forms W-8BEN to the IRS. Such a requirement would be consistent with the recommendations made in the ICG Report on Withholding Procedures and would permit the U.S. to share this information with its treaty partners. A concern is whether such a requirement would eliminate the attractiveness of the program for financial institutions.

5. The external review process should be strengthened. In what form the proposals made in Announcement 2008-98 are adopted and with what effective date should be monitored closely. While the wording of the proposals appears unclear and even overly broad in places, and the requirement of a US auditor overlay may well be too costly, the proposals do represent an attempt to address the concerns in the GAO Report and some of the concerns expressed in hearings before Congress.

In addressing these issues, consideration also must be given to the effect of a change in the playing field on the willingness of financial institutions to participate in the

program. Clearly there are burdens associated with being a QI and the changes considered would increase the burdens and, to the extent potential investors are less willing to invest through a QI, could reduce the benefits to those institutions. Recognition also must be given to the face that the scale of operations of smaller institutions makes them particularly sensitive to increased costs.